Mid-Year Outlook 2025

Research-powered investing

A global rewiring

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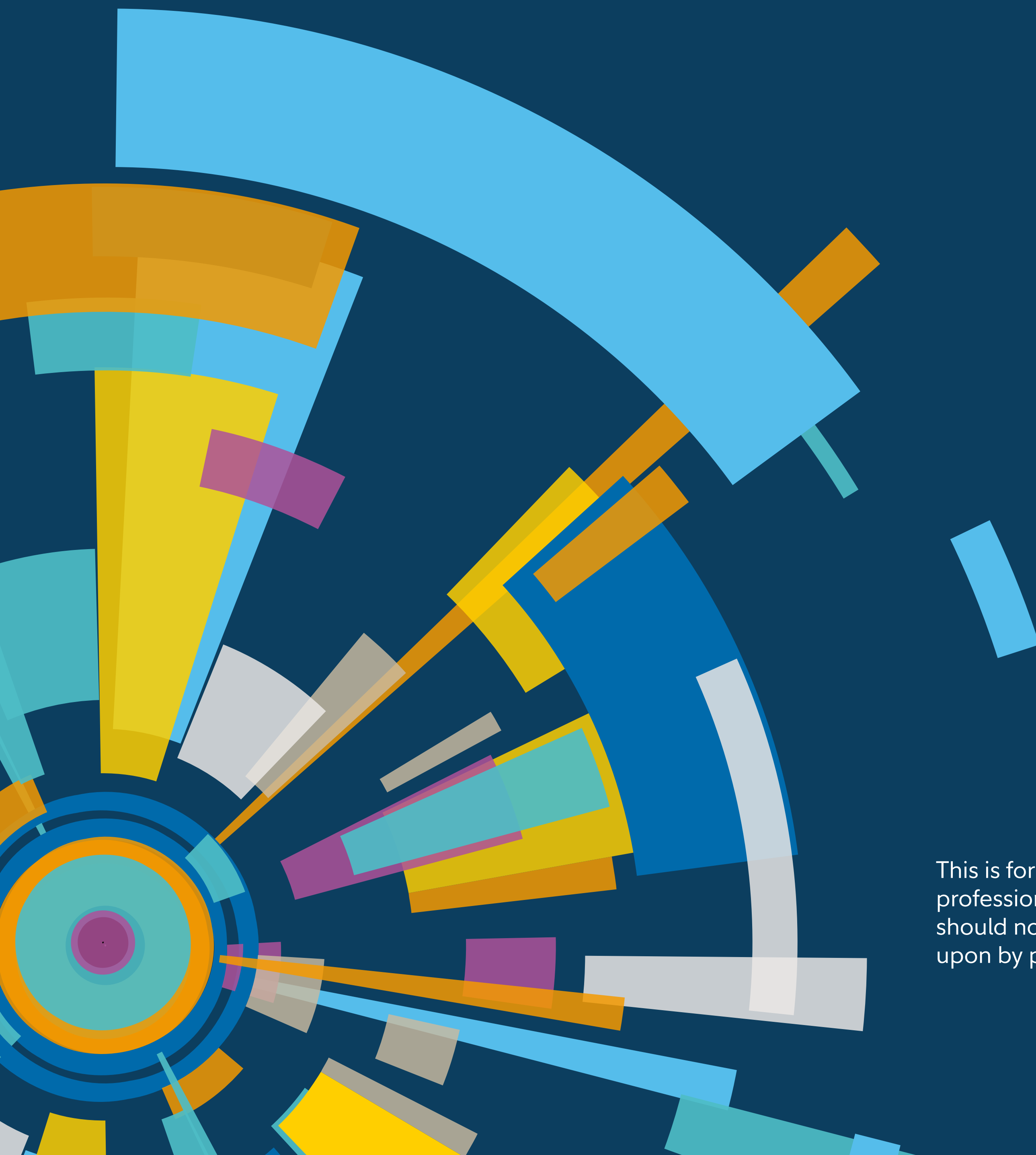

Class perspectives

A more volatile policy and market environment puts a premium on expertise.

The investment teams we lead spent a long time at the start of 2025 debating valuations. That we were doing so with such vigour was some indication of where we found ourselves. Not necessarily at dotcom-bust levels of overvaluation, but certainly at a point where there were real doubts over whether U.S. tech stocks, or credit, could continue as they had.

Fast-forward to early June, as we write this, and those instincts have been borne out, alongside a series of events which are arguably rewiring the world economic and security order. As uncertainty related to U.S. policy reaches all-time highs, there has been movement in credit spreads, sharp shifts in currencies and long rates, and stock market volatility in which everyone has taken a good hard look at the underlying solidity of the businesses they invest in. Our bank of analysts do this all the time, and as an institution we've proved to be well positioned for the moves of recent months.

There is still substantial risk from here – by which we mean both for profit and for loss. As our macro team outlines, the outlook for the U.S. economy has worsened significantly. Other economies look precarious too, and in global markets volatility has surged. The world's big investors are also naturally its big holders of mainstream assets for which the accepted wisdom is being questioned in ways not seen for a generation. We do not know yet where U.S. Treasuries or the dollar will end this year. But we can make projections, and we will make educated ones to shape investments across the various asset classes.

With that in mind, we've packed this year's mid-year outlook with a wide range of views, be they macro-, asset class- or sector-specific. Right at the top of our minds is the fate of the U.S. economy over the next few months, and you will find solid debate throughout this package of articles on the case for diversification, investors' chief defence in times of significant market and economic turbulence.

The case for Europe has clearly been strengthened, reflected in the market and our view of future earnings. More will be spent on defence and, whatever the domestic political arguments, a Germany that spends more is now a reality. Other central European economies are coming of age and are little exposed to U.S. tariffs. China too, we believe, will flex its fiscal muscle to achieve its economic and policy targets.

Shifting to well-managed income strategies has been an attractive play for many. On the fixed income side, the simple option of cash has also proved popular amid the volatility, but as rates come down there will be a tipping point where allocators look for more yield. Asian investors are looking more at European debt, and there are signs of a recovery of interest in emerging markets as the structural dollar bull run in play since 2013 shows signs of turning.

Henk-Jan Rikkerink and Salman Ahmed discuss the deep-seated fragmentation of the global order that may arise from today's policy shifts and its macro and market implications; Lei Zhu and Matthew Quaife consider the implications for China and the rest of Asia; and our latest survey of Fidelity International's company analysts digs into the impact of tariffs on the ground across regions.

We trust you'll be as stimulated by their ideas as we were.

Niamh Brodie-Machura
Chief Investment Officer, Equities

Andrew Wells
Co-Chief Investment Officer, Fixed Income, Multi Asset and Real Estate

"Accepted wisdom is being questioned in ways not seen for a generation."

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Investment outlook

A global rewiring

The world is likely to fragment through the rest of 2025 and beyond. Investors may want to adjust their portfolios to reflect the new order.

Henk-Jan Rikkerink
Global Head of Multi Asset,
Real Estate, and Systematic

Salman Ahmed
Global Head of Macro
and Strategic Asset Allocation

- The first half of 2025 has shown rapid market changes, with ongoing volatility expected for the remainder of the year.
- The deep-seated fragmentation of the global order, driven by U.S. and China policy shifts, will alter trade and capital flows, making diversification essential for investors.
- Private assets, real estate and emerging markets like India and Latin America offer attractive opportunities with relatively cheap valuations.

Tariffs, trade deals, tantrums: the first six months of this year have shown us how quickly markets can move. Expect more jitters in what remains of 2025.

More interesting for the long-term investor is the deep-seated fragmentation of the global order that will arise from today's policy shifts. The U.S. is pushing for reliable allies in supply chains, while China is being pressured to orientate away from supply-side stimulus toward domestic consumption. A managed decoupling between both countries in strategic sectors will push trade and capital flows along new geostrategic lines.

This may confuse the picture for investors, who have long turned to the U.S. as a relatively safe haven through previous bouts of volatility.

Diversification into alternative regions will be paramount in this new age.

Here are some of our top convictions for the remainder of the year:

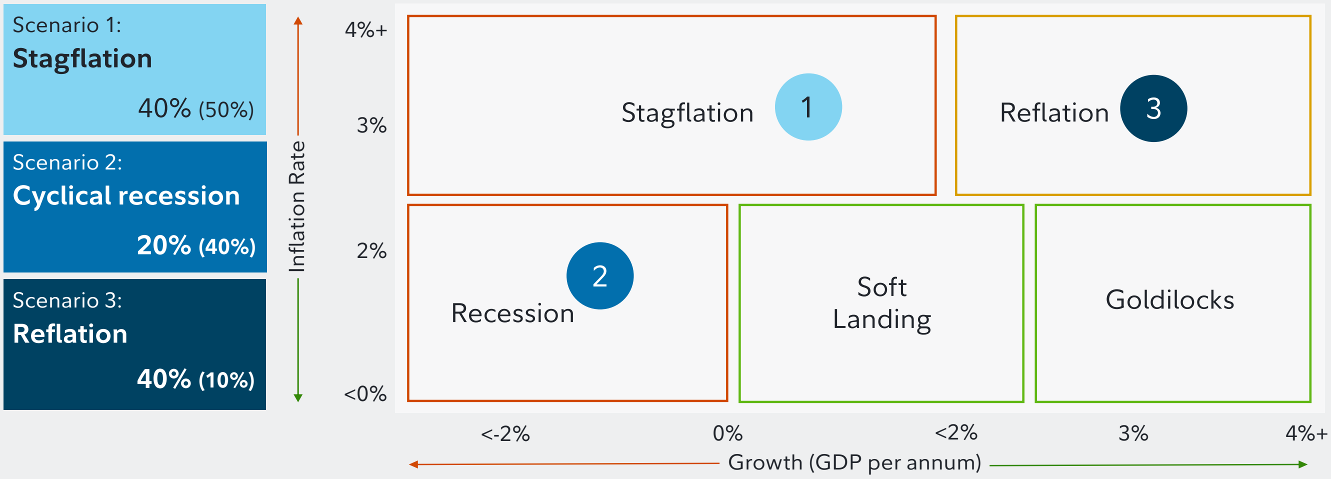
1. **Globally diversified portfolios:** Regional allocation will be more important as U.S. assets experience heightened volatility.
2. **Hard currency and local currency emerging market (EM) bonds:** These stand to gain from a weak U.S. dollar. Many are very cheap. Some, including Brazilian and Mexican bonds, boast attractive yields.
3. **The euro and Japanese yen:** These currencies should prove relatively stable and provide some of the defensive qualities lost from a turbulent dollar.
4. **EM equities:** The rally in China is better supported by fundamentals than on previous occasions. Valuations are relatively cheap. China, India and Latin America provide pockets of interest.
5. **Gold:** Likely to play its traditional role as a preserver of value as the dollar depreciates.

U.S. macro: Prepare for inflation.

Effective tariff rates currently stand at around 14%. This is likely to increase inflation in the U.S., to around 3.5% this year. We believe there is a 40% probability that this materializes as economic reflation, and a 40% probability of stagflation (where prices rise even as growth falls). Meanwhile, foreign-produced goods will compete to find a home elsewhere as demand diminishes in the U.S. This should result in deflation in the rest of the world.

Scenarios for the U.S. in 2025

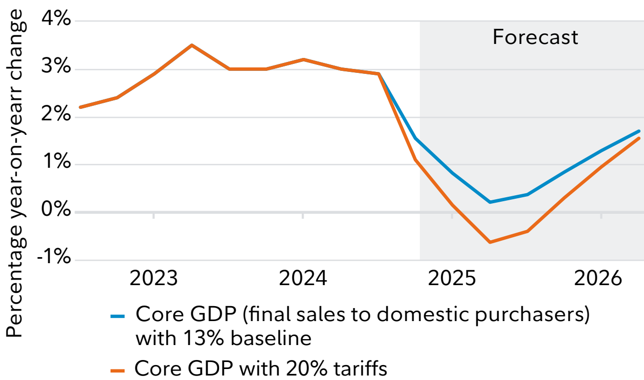
Our combined probability of stagflation and recession has moved down, but remains high, at 60%.



Note: Brackets reflect previous probabilities. Inflation rate measured by U.S. Core Personal Consumption Expenditures Price Index. Source: Fidelity International, May 2025.

Rising tariffs and volatile trade policy will also bring growth down to around 1% this year. While all-out recession is less likely if a de-escalation with China follows through, the picture remains uncertain. Were the effective tariff rate to rise to 20%, recession would be back on the cards.

Chart 1: Effective tariff rates at 20% would push the U.S. into recession.



Source: Fidelity International, Fidelity International Global Macro Team calculations, macrobond, BEA. May 2025.

All this leaves the U.S. Federal Reserve (the Fed) with a difficult balance to strike. We believe tariff relaxation and persistently sticky inflation mean the Fed is unlikely to cut rates this year (contrary to market expectations). But so long as the tariff picture remains unclear, so does the outlook for monetary policy.

Given the stagflationary risks in the U.S., investors will now look to alternative shores for growth hedges. Most other central banks – Japan and Brazil aside – are in a cutting cycle. We anticipate the European Central Bank will maintain its quarterly cutting cadence toward a policy rate of 1.5% (and potentially lower if a trade war escalates), while improving inflation data amidst a softer labour market in the U.K. will facilitate further cuts for the Bank of England too.

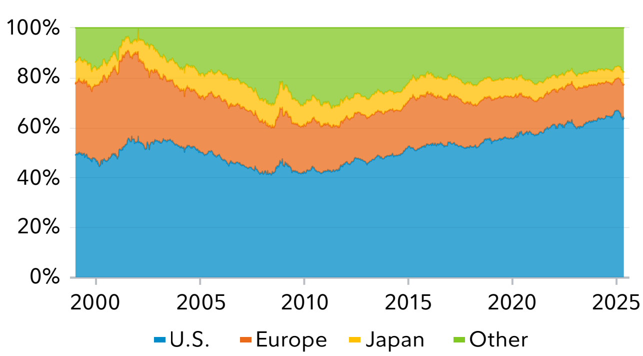
Broadening horizons

The diverging inflationary picture is symptomatic of a deeper-set structural rewiring of the global economy. President Trump is determined to restore manufacturing to the U.S. and reduce the size of the U.S. current account deficit by way of tariffs, while striking trade deals with friendly countries. China likewise is trying to support domestic consumption and increase the size of its service economy. Over the long term, we expect to see a fragmentation of the world's economic, technological and security order as both pursue more isolationist policies.

One likely consequence of these changes is a potential rebalancing of U.S. assets in investors' portfolios. The U.S. dollar is most obviously at risk, given that its status as global reserve currency has fed into the twin deficits that Trump is now trying to reduce. The effectiveness of the U.S. dollar as a hedge to equity risk is also coming under question, building on today's dollar depreciation as foreign investors lift hedge ratios.

Diversification has always been important. Now it is imperative for portfolios that have become increasingly reliant on U.S. assets over the past 25 years. Capital outflows and a dollar depreciation mean index weightings will look very different in the future. Those who get ahead of these structural trends may stand to benefit as portfolios rebalance.

Chart 2: U.S. assets dominate today's portfolios.
MSCI All Country World Index



Source: Fidelity International, May 2025.

The euro could prove a significant beneficiary from the repatriation of flows, while newly expansive German fiscal policy signals the potential for a revival of the region. The valuation and defensive characteristics of the Japanese yen also make this currency appealing, while gold should continue to respond well to any further geopolitical ruptures.

Emerging markets are attractive. Debt will be buoyed by dollar depreciation; some countries such as Brazil and Mexico already offer very attractive yields. EM equities look relatively cheap. The market is underpinned by Chinese stocks, which have turned a corner following AI breakthroughs in the country.

Private assets, including real estate, offer further diversification potential. That's particularly useful given their long-term investment horizon and active ownership in many strategies, providing investors with the ability to make adjustments to evolving market dynamics. Likewise, investors may find alternative opportunities in real estate, especially through higher income-yielding European markets which can protect against inflation, and through the value-add of "greening" previously unsustainable buildings.

And there is still room in a diversified portfolio for U.S. equities. The S&P 500 comprises many of the world's biggest and most innovative companies, which are highly profitable and shareholder friendly. It would be unwise to bet against the U.S. entirely; but equally it is not the only game in town.

Fickle fiscal

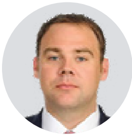
Fiscal policy also supports the case for portfolio rebalancing. It is impossible to ignore the U.S. debt burden, and the country shows no sign of stabilizing its trajectory. It is running wartime-level deficits at a time when the unemployment rate is at cyclical lows. High volumes of treasury issuance paired with today's volatility are creating a risk premium on long-term debt as the imbalances between supply and demand become more prominent. This further erodes the appeal of U.S. Treasuries as a safe haven and strengthens the case for diversification elsewhere.

One such area could be German Bunds. U.S. foreign policy and the need for Germany to boost internal investment in infrastructure and defence spurred the country to initiate a fiscal U-turn earlier this year. There is still ample room for more issuance, given Germany's track record of fiscal rectitude.

Asia: The diversification trade

The ongoing divergence between economies presents a new reality for Asia. At the same time, it offers exciting diversification opportunities across the region.

Lei Zhu
Head of Asian Fixed Income



Matthew Quaife
Global Head of Multi Asset

- While Asia's reliance on trade makes it highly vulnerable to tariff tensions, many of the region's central banks have room to ease monetary policy, offering a buffer against their impact.
- Investors are reallocating funds from traditional safe havens towards Asia, drawn by its potential for growth, currency appreciation, and evolving consumer markets.
- Despite the near-term uncertainty caused by U.S. tariffs, Asia's long-term growth prospects remain robust, supported by ongoing favourable structural shifts in China, Japan and India, and strategic positions in the AI supply chain for countries like South Korea and Taiwan.

Asian markets breathed a sigh of relief after the U.S. and China reached a temporary agreement on tariffs in May. But after all the surprises, twists and turns, to say a great deal of uncertainty remains is fast becoming the clichéd understatement of the year.

One thing is for sure. We are in a new era of geoeconomic fragmentation. Neither the U.S. nor China says it wants to fully decouple from the other, yet there is growing evidence of that happening in strategic areas. Asia's reliance on trade as an engine for growth leaves it particularly exposed to those tensions. Meanwhile, frequent shifts and reversals in trade policy make it doubly challenging for governments to deliver timely fiscal and monetary policy responses.

However, compared with others, many Asian central banks have more monetary room to soften the impact of tariffs on their economies. While inflation remains sticky in the U.S., it is cooling in most of Asia, and a recent surge in the region's currencies gives central banks more leeway. We expect to see more monetary easing through the second half of 2025. Investors looking to diversify their portfolios through this new era will find much to like in Asia.

Here are some of our top convictions for the months ahead.

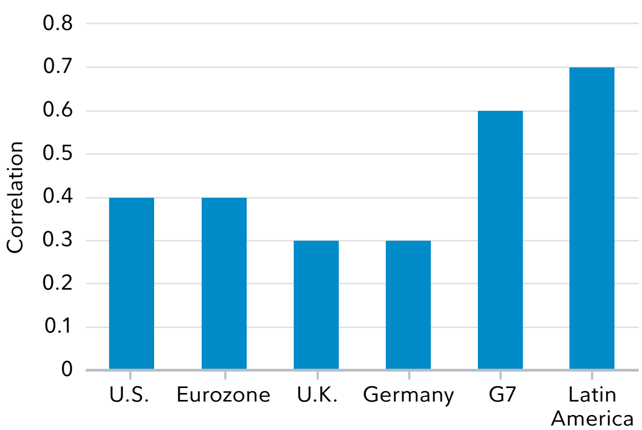
1. **Asia's investment-grade local currency government bonds:** These are now an appealing diversification play, which will benefit from potential interest rate cuts.
2. **Currencies:** Remain historically cheap even after the recent rally.
3. **China technology stocks:** China's ongoing shift from the world's factory to the world's innovator will further unlock the growth potential of tech firms.

Compelling grounds for diversification

Uncertainty around U.S. trade policy, combined with its growing debt burden, is pushing global investors to reallocate funds away from the traditional safe havens of the U.S. dollar and long-duration U.S. Treasuries. There are a number of areas where Asia is set to benefit from the shift.

We like Asia's investment-grade local-currency government bonds. They exhibit low-to-moderate correlations with major global peers, which makes the asset class a good diversification tool. After years of development, the markets are far deeper than they once were, driven by growing economies and increasing support from regulators. More index providers have added the region's local currency bonds to their global indexes, enhancing the appeal of the asset class. Central bank rate cuts and the potential for currency appreciation should lead to a boost in demand for the asset class.

Chart 3: Ten-year correlation between Asia local-currency government bonds and major global peers



Source: Bloomberg and Fidelity International, June 2025. Note: Correlation data are based on monthly returns (unhedged) of Bloomberg, ICE BofA, FTSE and JP Morgan indexes that focus on sovereign debt. Data as at March 31, 2025.

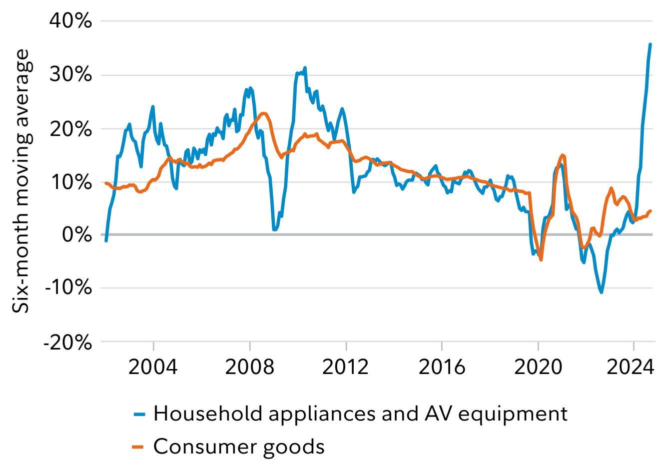
Despite the recent rally, Asian currencies still look cheap relative to their historical long-term averages, as measured by the real effective exchange rate.

Demand for the region's currencies is likely to pick up further as investors seek dollar alternatives and position for ongoing tariff talks.

Change is afoot.

Structural shifts in Asia's biggest economies are strengthening arguments for regional allocations too. Chinese policy makers have been focusing more on supporting domestic consumers as part of the country's moves to achieve its target of around 5% growth this year. In March 2025, the government expanded a state subsidy program that provides discounts on purchases of new consumer goods. The targeted approach is starting to help: the six-month moving average for sales of home appliances jumped in April by the most on record.

Chart 4: Stimulus is working.
China home appliance sales spike on government support.



Source: China National Bureau of Statistics, Macrobond and Fidelity International, June 2025.

There is still some way to go, however, for the country to rebalance its economy toward consumption-led growth, including building out its threadbare social safety net and funnelling more resources from factories to households.

The stratospheric rise of AI start-up DeepSeek earlier this year took the world by storm, marking a turning point for how global investors perceive the Chinese tech sector. No longer just the world's factory, China is now a worthy rival for the title of the world's innovator. Despite U.S. export controls, advancements are being made across sectors as the country embraces many new technologies at a faster rate than anywhere else. We think this momentum has further to run, with more growth potential in tech stocks.

Beyond China, Japan's reflation story remains intact. After decades of stagnation, the "virtuous wage price cycle" policy makers have been aiming for is well under way. Major Japanese companies have promised large pay increases for their workers this year. The wage growth is expected to translate into a recovery in consumption. While export-oriented sectors are reeling from U.S. tariffs, domestically focused companies, such as banks, should fare better.

India, which has a large and young population and low dependence on exports, is well positioned to withstand uncertainties in a global trade slowdown. The policy backdrop, with monetary easing and fiscal consolidation, will help the economy pivot toward private sector-driven growth. Cuts to income tax will enhance the purchasing power of the country's rising middle class, helping to offset the weakening outlook for global demand.

Others stand to benefit from the developing AI story – for example, leading chip makers in South Korea and Taiwan, thanks to their strategic positions in the AI supply chain. Despite uncertainty surrounding potential tariffs, the robust AI demand will support their promising outlook.

The long view

There's no denying that the challenges posed by U.S. trade policy for Asia more broadly are acute and could lead to a slowdown in export orders, while weighing on corporate confidence and delaying capex plans.

But while the region's economic outlook may be challenged in the near term, the reshaping of the world order in manufacturing, trade and technology means global investors can't ignore Asia's diversification benefits and long-term structural growth potential.

Analyst survey: Winners and losers from new trade order

Tariffs – and their knock-on effects – create fresh cost pressures for companies around the world. But the effects will not be distributed evenly.

Monica Li
Director of Research

Terry Raven
Director of Research

Rebecca Motta
Director of Research

- Analysts from Fidelity International highlight how companies with pricing power, particularly in sectors like information technology, consumer staples, health care and industrials, may better manage tariff-induced cost pressures. However, weak demand in certain subsectors, like luxury goods, could constrain pricing power.
- Analysts suggest that shifting production locations might mitigate some tariff costs, though this could lead to further inflationary pressures, such as labour shortages.
- Companies in developed markets may be more affected by trade tensions than those in regions like Asia-Pacific and China, where analysts report more positive or neutral effects from changing policies.

The topic of trade war looks set to dominate analyses for the remainder of 2025, dividing the corporate world into those who are bracing for it and those looking to jump on opportunities.

Investors will naturally want to identify who is who, taking account of second-order and relative effects, while also staying mindful of the macroeconomic context.

Cost inflation fears vary by region

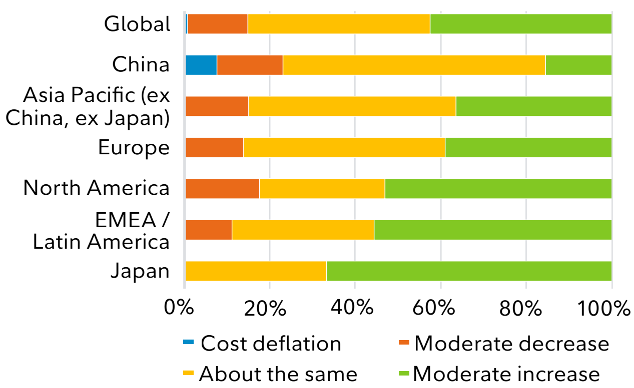
The bottom-up view from Fidelity International's analysts shows regional divergence when it comes to cost inflation expectations, echoing our overall mid-year outlook.

For example, 53% of North America analysts expect moderate cost inflation increases, an expectation that's also shared by a majority of Japan and EMEA/Latin America-focused analysts.

Elsewhere, though, while a fair number predict greater inflationary pressures in the cost bases of the companies they cover, most analysts globally expect those pressures will stay the same or decrease.

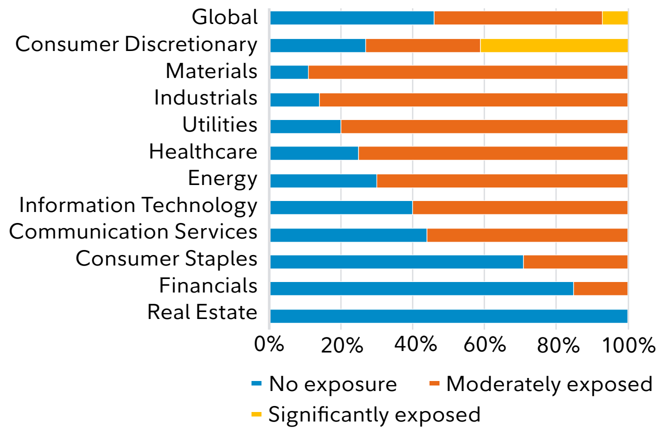
> "53% of North America analysts expect moderate cost inflation increases."

Chart 5: Mixed expectations for companies' cost inflation



Question: How, if at all, do you expect inflationary pressures within your companies' cost bases to change over the next 12 months? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

Chart 6: Tariff targets on their backs



Question: How exposed do you think your companies' costs are to any permanent changes in the level of tariffs they face? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

One factor that could keep rising costs in check is a decline in oil prices.

"OPEC+ are reinstating their supply faster than had previously been expected," notes James Trafford, an equity analyst who covers the sector. "For now, the oil price has been surprisingly resilient, but it may drop in the second half of the year once those barrels are actually starting to be produced."

Of course, higher tariffs do represent an obvious source of one-time, cost-push inflation, with consumer discretionary firms looking particularly exposed.

"A significant proportion of my companies' goods are imported from Asia," says Cameron Ho, a North American retail analyst.

Zak Gibson, a consumer discretionary analyst for EMEA and Latin America, agrees: "Apparel is 90% imports from China."

> "Retailers passed through food inflation without issue during the 2022–23 inflation cycle, tariff inflation is likely to be smaller."

By contrast, financials, real estate and consumer staples are the sectors with the lowest proportions of analysts saying their companies' costs are exposed to tariff changes.

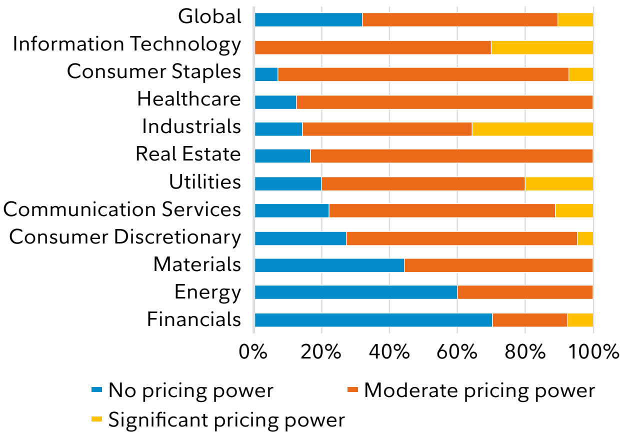
"Banks consume an immaterial amount of imported products," says Canadian financials analyst Thomas Goldthorpe, although he adds that a knock-on effect of tariffs could be lower loan growth if the economy weakens.

Which companies have pricing power to pass on costs?

For those businesses whose cost bases have higher exposure to tariffs, pricing power will be key in determining whether they can maintain margins. Here again the picture is mixed. Information technology, consumer staples, health care and industrials are the sectors with the largest proportion of analysts who say their companies have moderate or significant pricing power.

"Retailers passed through food inflation without issue during the 2022–23 inflation cycle," says North America-focused consumer staples analyst Andrew Hall. "And the tariff inflation is likely to be smaller."

Chart 7: Power to (pass on costs to) the people



Question: To what extent do you think your companies have the pricing power to pass on the cost of tariff changes to their customers? Chart shows percentage of analysts. Source: Fidelity International, May 2025.

"Engine companies have the best pricing power of any industrials," adds Oliver Trimingham, who covers European aerospace. "They occupy monopoly or duopoly positions, with mammoth barriers to entry, and utterly captive customers."

Jonathan Tseng argues that similar dynamics grant significant pricing power to the semiconductor producers he covers: "It's a consolidated industry. And it's hard to make this stuff."

"My companies are mostly high-quality businesses with pricing power and peers with similar supply chains," says Dominic Hayes, an industrials sector equity analyst covering capital goods makers. "So, the main question is the degree of demand destruction."

In some sub-sectors, weak demand is already imposing a constraint on pricing power.

"Historically, I would have said my companies have significant pricing power," says equity analyst Emma Cunningham. "However, luxury companies have pushed pricing too much since COVID, which puts them in a more difficult position to do so today. Consumer demand is choppy, with fatigue across vast portions of the consumer sector, including luxury."across vast portions of the consumer sector, including luxury."

The case for – and costs of – relocating production

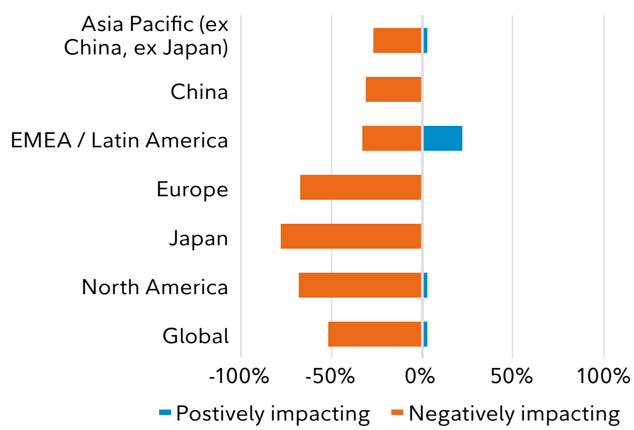
As things stand, most analysts say current trade policies are negatively affecting their companies.

Companies can respond to rising costs by shifting production to different locations depending on the level of tariffs.

"I think my companies can change their supply chain structure," adds Penn Bowers, an equity analyst who covers Japanese gaming companies. "So on a short-term basis they may be exposed to tariff changes, but on a longer-term view they can adjust fairly easily."

For some sectors, though, shifting production wouldn't be a straightforward fix, especially if lots of businesses are trying to do the same thing all at once. While a reordering of global supply chains might well minimize tariff costs at the individual firm level, it could nonetheless represent a further inflationary impulse beyond the initial tariff shock.

Chart 8: Supply chains under strain



Question: To what extent are current trade policies affecting your companies' supply chains relative to how they typically operate? Chart shows percentage of analysts. Analysts who responded "No impact" are not shown. Source: Fidelity International, May 2025.

"If companies rapidly try to relocate to the U.S., that could lead to labour shortages and an increase in labour costs," says automotive fixed income analyst Andras Karman.

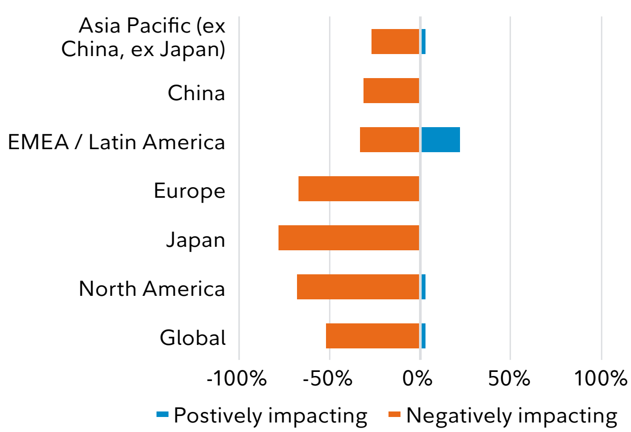
Asia-focused analysts are relatively sanguine.

Interestingly, as Chart 8 above shows, most analysts who cover Asia-Pacific, China and EMEA/Latin America say current trade policies have either no impact or a positive impact on how their companies currently operate. This suggests that if trade tensions persist, it's companies in developed markets that could feel the brunt.

Chart 9 tells a similar story, where a notably smaller proportion of analysts covering Apac and China expect supply chain issues to adversely affect their companies' earnings compared with other regions.

"There's no big direct impact from tariffs to domestic consumption," says China-focused consumer staples and sportswear analyst Alex Dong, although he adds that the overall picture is gradually weakening against a current backdrop of limited fiscal stimulus to spur consumption.

Chart 9: Relative calm in Asia around supply shortages



Question: How, if at all, could (non-labour) supply shortages/issues impact your companies' earnings over the next 12 months? Chart shows percentage of analysts. Analysts who responded "No impact" are not shown. Source: Fidelity International, May 2025.

Evan Delaney, a fixed income telecoms analyst covering North America, sees more direct tariff-related consumption headwinds in his sector: "Tariffs are likely to make handsets like iPhones more expensive. All else being equal, this will make a consumer less likely to upgrade their plan, slowing subscriber and pricing growth."

But it's not just the absolute effect of tariffs that investors should consider. Relative impacts will have a big part to play in deciding who the winners and losers are.

"The current base case is that Indian textile players may see relatively better tariffs versus peers," says equity analyst Priyadarshee Dasmohapatra, who covers the space. "If that happens, they will end up having better bargaining power."

> "A consumer is less likely to upgrade their [phone] plan, slowing subscriber and pricing growth."

There are also, as always, second-order effects to consider. If we do, as expected, see persistent inflation in the U.S. economy for the rest of the year, this too will create winners as well as losers.

"Given the probability of U.S. Federal Reserve interest rate cuts has decreased since the tariffs, I expect banks to maintain relatively healthy net interest margins in the next 12 months," says Sukhy Kaur, a financials fixed income analyst. "High inflation is also generally good for the insurance broker sector."

To end on a positive note, though, whatever further challenges tariffs may or may not create, they will not be the first big tests that management teams have faced this decade.

"I think managing through the COVID supply chain disruptions has left business models better prepared to handle this situation," says European industrials analyst Abhishek Dhawan. "So, we should not underappreciate the ability of cyclicals to be able to navigate this better than in the past."

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